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The Australian Economy: Hawke's Hurdle to Reelection

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An Intelligence Assessment

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*EA 87-10011
April 1987*

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The Australian Economy: Hawke's Hurdle to Reelection

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An Intelligence Assessment

This paper was prepared by [redacted]
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The Australian Economy: Hawke's Hurdle to Reelection

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Key Judgments

*Information available
as of 1 March 1987
was used in this report.*

Australia's two-year economic downturn threatens Prime Minister Hawke's reelection prospects. In our judgment, it is unlikely that the economy can recover significantly before the national elections that must be scheduled by Hawke for no later than April 1988. Real growth is likely to be no more than 2 percent for the fiscal year ending in June, while unemployment has held above 8 percent since mid-1986 and inflation is near 10 percent. Also worrisome is the country's US \$67 billion foreign debt that is six times what it was in 1980 and that absorbed 38 percent of export income for debt service in 1986. This situation gives the opposition Liberal-National coalition—led by John Howard—a good opportunity to defeat the four-year-old Hawke government as Canberra faces the problem of how to manage the economy without driving voters into the arms of the opposition:

- Conservative business and farm groups, increasingly disenchanted with Hawke's economic policies, are forcing Hawke to consider adopting policies normally rejected by the Labor Party's trade union constituents, such as reviewing work practices and cutting social spending.
- Relations within the Cabinet and among Labor Party factions are strained, as Hawke's government has frozen spending this year and encouraged wage restraint in an effort to reduce the budget deficit and improve Australia's balance of payments.

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Canberra's twin priorities of shrinking Australia's rapidly widening current account deficit to a sustainable level and arresting the Australian dollar's two-year slide in international money markets have been the hallmark of Hawke's economic policies since his reelection to a second term in 1984. Australia's dependence on mineral and agricultural commodities for its export earnings is a major shortcoming; world commodity markets show no sign of improving significantly between now and election time.

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Australia's ability to increase manufactured exports—another route to improving the current account deficit—is hampered by high labor costs and by high tariffs that have made Australian manufacturers uncompetitive in world markets. Moreover, domestic investment in manufacturing will weaken if firms continue to invest overseas because no major reform of Australia's labor laws is in sight. The Hawke government has proposed reforms to increase manufacturing efficiency, but the party's left wing and trade union supporters are preventing major changes that they fear would cause a loss of jobs.

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Although Hawke remains the most popular politician in Australia, we believe that he will have difficulty managing economic policy in the runup to national elections. Hawke may institute minor reforms, if for no other reason than to show the electorate that the Labor government is doing something about the economy, but the government has abandoned major proposals, such as a consumption tax, rather than risk public anger. The Labor Party, nonetheless, trails the opposition Liberal-National coalition in recent public opinion polls 48 to 42 percent—despite divisions in the opposition leadership—because the public continues to give the government poor marks for its handling of the economy. For this reason, we believe that Hawke and his advisers will wait as long as possible, hoping for some improvement in the economy, before calling a snap election, probably in early 1988.

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Because the Hawke government has failed to make major reforms to curb trade union wage demands and to liberalize tariff regimes, Australia's economic problems seem certain to persist in the near term. Economic growth will probably remain sluggish as long as demand for Australian raw materials is depressed, thereby undermining Canberra's efforts to prop up the Australian dollar. A weak dollar and high wage demands will almost certainly fuel inflation and high interest rates.

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An extended period of economic sluggishness, especially in Australia's agricultural sector, could strain ties to the United States. Hawke's pro-US defense and foreign policies have been challenged by leftists and farmers who blame Washington's agricultural subsidy programs for undermining the Australian economy. Although Hawke has resisted pressure from these groups to tie the continuation of the US-Australian joint defense facilities to Washington's cooperation in rolling back agricultural subsidies, we believe that a protracted economic slump will cause the Labor government to curb military spending and increase pressure on Hawke to reduce his support for Washington. If Howard's coalition wins the election, in our judgment, a Liberal-National government would carry out limited domestic economic reforms and would strongly support the US-Australian joint defense facilities, US naval ship visits, and the Strategic Defense Initiative.

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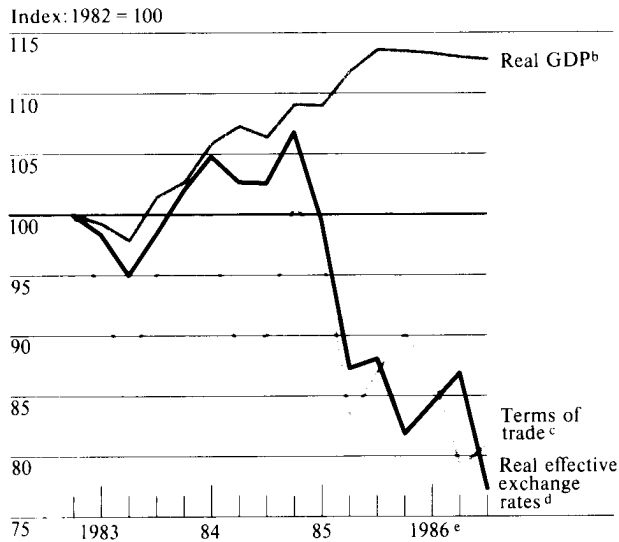
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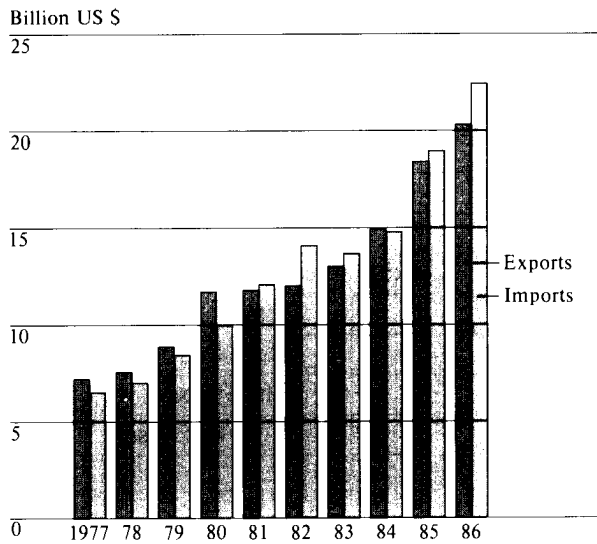
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Figure 1
Australia: Economic Indicators^a

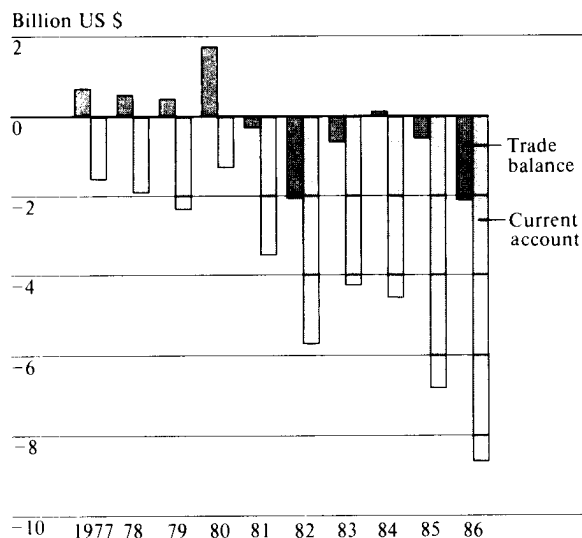
Indexes of Real GDP, Trade and Exchange Rates, 1983-86



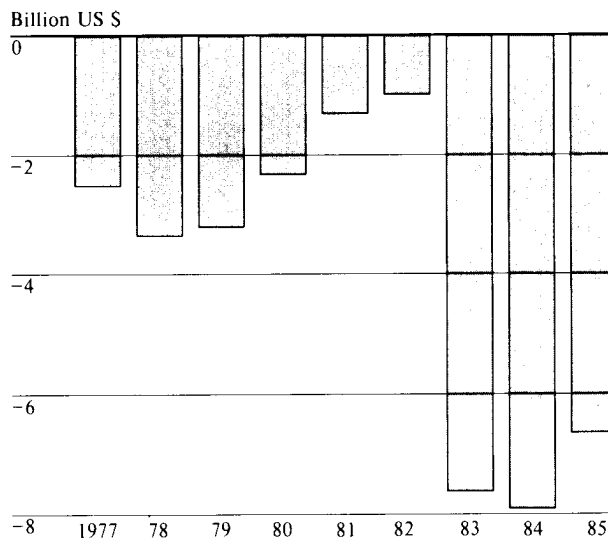
Exports and Imports, 1977-86



Trade and Current Account Balances, 1977-86



Government Deficit, 1977-85



^a Data for fiscal quarters beginning 1 July of the stated year.

^b Adjusted for inflation.

^c Index of the ratios of export prices to import prices.

^d Index of trade-weighted exchange rates adjusted for relative inflation rates among Australia's major trading partners.

^e Estimated for second and third quarters.

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The Australian Economy: Hawke's Hurdle to Reelection

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Fallout From the Economy

Australia's economy is mired in a two-year-long recession that we believe will determine Prime Minister Hawke's political future in national elections that must be held by April 1988. Although Hawke's personal popularity remains high as he enters his fifth year in office—61 percent of opinion poll respondents prefer Hawke as prime minister, as compared with 24 percent for his closest challenger, opposition leader John Howard of the Liberal-National coalition—the recession is dividing Hawke's Labor Party and strengthening political action groups opposed to his economic policies. []

The poor performance of the economy during the last year, for example, has increased tensions between trade unions and other segments of Australian society, most notably business leaders and farmers, making Hawke's job of balancing competing interests more difficult and, in our judgment, almost certainly costing Hawke and the Labor Party votes. We believe that, in order to be reelected, Hawke at a minimum must retain the support of trade unions by allowing wage rates to keep pace with inflation—but this runs the risk of driving other constituencies, such as the business community, into the arms of the opposition coalition. []

We believe that Howard has a stronger grip on the opposition leadership and is in a better position to challenge Hawke than at any time since becoming coalition leader in September 1985. Although a leadership challenge before the next election from former opposition leader Peacock is widely expected by political observers in Australia, in our judgment Howard—who has the support of Liberal Party officials—would maintain control of the opposition coalition. Although polls show that the Australian public generally gives Howard low marks for his performance as opposition leader, the Liberals are aware that a leadership change at this late point would almost certainly assure an opposition defeat in the elections. Howard, moreover, is capitalizing on Hawke's economic problems

and the increasingly conservative mood in Australia. Despite a reputation as a colorless leader, Howard, we believe, could effectively pressure Hawke on economic issues and might force the Labor Party to run a defensive, issue-oriented campaign. []

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Facing a Weak Economy

Standard economic indicators reported frequently in the Australian media paint a gloomy picture of the country's economy:

- For the second year in a row, inflation-adjusted gross domestic product is likely to grow by no more than 2 percent for the fiscal year ending 30 June 1987, compared with annual growth rates of more than 6 and 4 percent in 1984 and 1985, during the Hawke government's first term.
- Unemployment is rising—holding above 8 percent since June 1986. It had been in a steady decline from a near record 11 percent since February 1983, just before Hawke was elected to his first term.
- The government's tight monetary policy during 1984 and 1985—designed to attract foreign capital to finance the country's deteriorating balance of payments—has produced some of the highest interest and inflation rates in the industrialized world. For over a year the prime rate has remained above 18 percent and the annual inflation rate is near 10 percent, according to press reports. []

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Australia's external finances, however, are the greatest cause of concern in Canberra, according to press reports. Last May, Treasurer Paul Keating, who is largely responsible for economic policy making in Hawke's government, startled Australians and international financial analysts by commenting that the nation would become a banana republic unless Australians tightened their belts. Although Canberra

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***Structural Weaknesses in the Australian Economy:
Barriers to Increasing Exports***

Changing patterns of international trade suggest that Australia's economic decline could well be long lasting. Some Australian economists, for example, believe that depressed world commodity prices signal the end of the "lucky country" era when Australia's natural resource wealth guaranteed high export earnings. As recently as 1985, more than three-fourths of Australia's export earnings were from mineral and agricultural commodities, even though only 7 percent of Australians work in these industries. Twenty-one of Australia's top 25 exports are primary products and nine out of Australia's 10 fastest growing exports are primary products. []

According to industry analysts, Australian manufactured exports are not competitive on world markets largely because domestic manufacturing is generally inefficient. In our judgment, an improved Australian competitive position requires fundamental changes in wages, tariffs, and investment incentives that recent conservative governments—much less Labor governments—have been unwilling to make. []

High-Cost Labor. Australia's more than 300 trade unions have a pervasive influence on the economy, which has one of the highest rates of strike activity among industrialized countries and wage increases that have exceeded productivity gains. According to an estimate from a multinational company, unit labor costs—the ratio of labor costs to the value of goods produced—have increased more than 200 percent since 1970. More than one-half the work force is unionized, as compared with the OECD average of 35 percent. Moreover, the small, often highly factionalized unions, are trade based rather than industry based. As a result, a strike in one industry often

hinders production in a wide variety of industries, ensuring that wage and benefit demands usually will be met. []

Moreover, Australia's constitutionally established wage bargaining system makes its labor market unresponsive to changes in world demand because the system ignores the competitive position and profitability of individual companies. The system includes federal and state industrial tribunals that arbitrate wage negotiations between unions and employers on a quarterly or half-yearly basis. Because the commissions traditionally award wage increases by trade sector, rather than by industry or employer, individual companies are often forced to pay wage rates beyond their capacity to pay, resulting in higher labor costs and limiting the ability of Australian firms to compete in international markets. []

Hawke has improved the labor situation at least marginally. In April 1983 the Australian Council of Trade Unions (ACTU) entered into a Price and Wage Accord with the Hawke government that guaranteed a moratorium on strikes in return for the federal Arbitration Commission's indexing wages to inflation. During the first three years of the Hawke government, this agreement resulted in the lowest numbers of man-hours lost to strikes since 1968. Because the agreement began to contribute to inflation, however, Hawke and Keating were able to convince trade unions and employer groups to agree to decouple wages from the consumer price index in favor of wage bargaining by industry. In our judgment, the compromise proposal should add some

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flexibility to the wage bargaining system, while limiting strikes by preserving employee benefits and guaranteeing modest wage increases. []

High Tariff Rates. Tariffs, now above 100 percent on some items, allow Australian firms to sell their products domestically at prices above the world market, thus providing little incentive to improve efficiency and increase exports. Moreover, because Australia's domestic market for manufactures is small, mass production techniques are not widely used unless the firm exports. As a consequence, even if Hawke's government restructured tariffs, we believe that expanding Australia's relatively small manufacturing base would take several years. []

Low Domestic Investment. Another reason that domestic production capacities will remain restricted for some time is the reluctance of Australians to invest in their own country. In our judgment, persistent pessimism in the business community about the economy's future can be seen in the fact that real business investment increased at an average annual rate of approximately 5 percent between 1980 and 1985—only about half the rate of inflation. To make matters worse, a recent survey suggests that investment in manufacturing industries this year, when adjusted for inflation, is likely to fall 3 percent. According to Australian economists, investment has been depressed because business leaders see no reform of labor laws in sight. As a result, investors believe that better returns can be found overseas. In 1985, for example, Australian investment abroad was 58 percent higher than the year before, and an Australian financial publication reported recently that, for every dollar of domestic investment, four dollars were invested overseas. []

normally incurs large trade deficits, the 1986 figures are extreme even by Australian standards. The data show that the current account deficit reached 6 percent of gross domestic product for the year ending June 1986, nearly twice the average recorded in the early 1980s. []

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Another aspect of Australia's deteriorating balance of payments that is increasingly worrisome to Canberra is its foreign debt of US \$67 billion in January 1987, which, when measured in Australian dollars is six times what it was in 1980. Last year 38 percent of export income was absorbed for debt service payments compared with only 8 percent in 1980. At 29 percent in 1986, Australia's ratio of debt to gross domestic product was slightly larger than the comparable ratios for Argentina and Brazil. []

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The Sliding Currency. As a result of its weakening external accounts, the Australian dollar has taken a beating in international currency markets. Since February 1985 it has depreciated by about one-fourth against the US dollar to a low of US \$0.59 in July 1986. According to press reports, the Australian dollar's decline, which has made imports more expensive and has contributed to inflation, has reinforced the public's discontent with the Hawke government's decision in December 1983 to float the dollar, which reversed Canberra's traditional policy of maintaining fixed exchange rates. []

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Canberra is turning to more stringent fiscal policies, in hopes of halting the dollar's slide and easing balance-of-payment strains. In August 1986, Keating presented an austere budget for fiscal year 1986/87¹ that, after adjusting for inflation, allows no real growth in expenditures. All areas of the budget were affected, including defense and foreign aid as well as

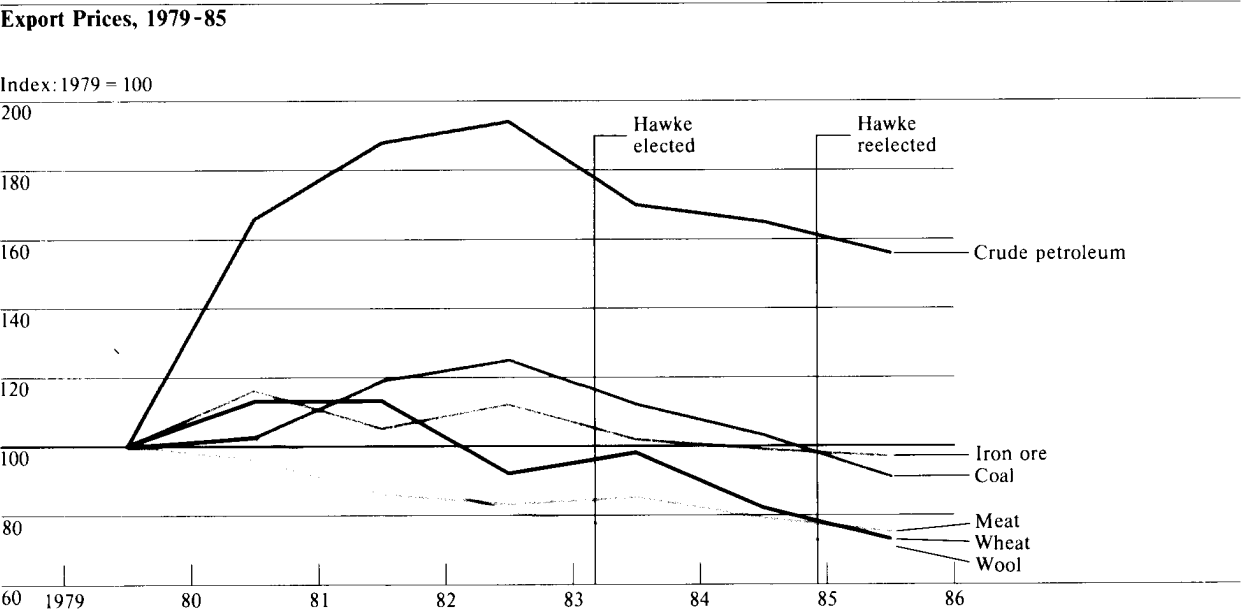
¹ The fiscal year begins on 1 July. []

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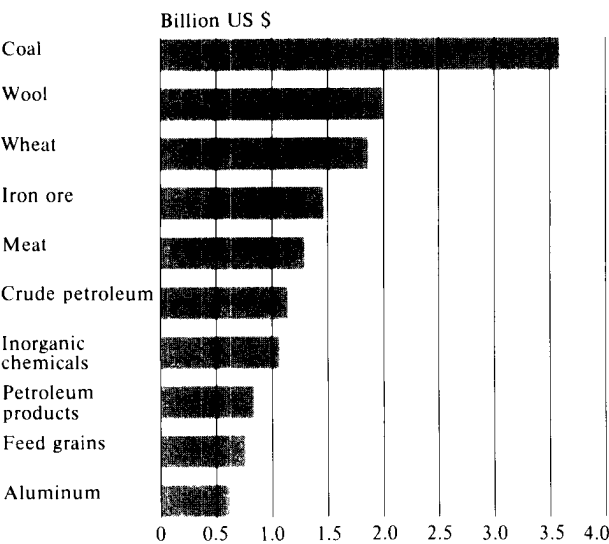
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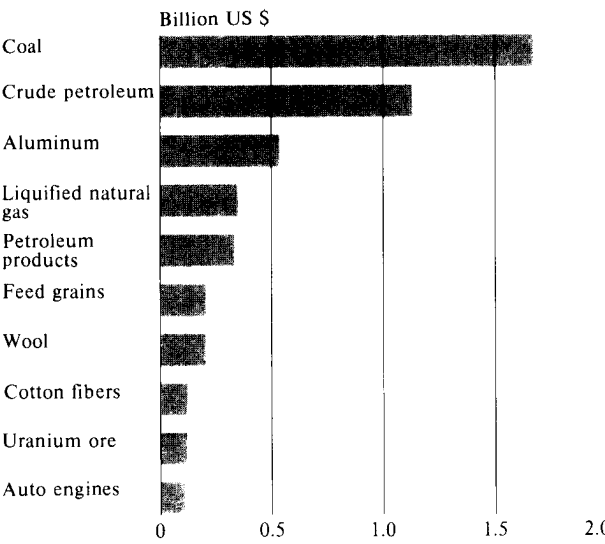
Figure 2
Australia: Selected Export Commodities



Top Ten Exports, 1985



Fastest Growing Exports as of 1985^a



^a Growth of exports since 1980.

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social welfare benefits, health, and education, but the hard bargaining over social programs strained the highly factionalized Labor Party, according to press reports. Although the party's Socialist Left argued for expansionary spending and angrily denounced the government's decision to end a ban on uranium exports to France, Foreign Minister Hayden's moderate Center Left members joined Hawke's relatively conservative Labor Unity faction in approving Keating's budget. []

In another attempt to halt the currency's slide, Canberra in July 1986 eased restrictions on foreign investment—51 percent local equity is generally required in any project—and removed a series of taxes on interest, dividends, and profits remitted to foreign investors. These measures were controversial within the Labor Party, but we believe, on the basis of the tenor of press reports at the time, that Hawke was able to push them through because the fall of the dollar had produced a sense of panic in the party's parliamentary caucus. Nonetheless, these actions and Keating's budget have not mollified the edgy currency market. The Australian dollar, at US \$0.67 in March 1987, remains weak, and Australia's credit rating has been downgraded by international financial analysts, according to press and US Embassy reports. Financial analysts are also predicting that, because world prices for primary commodities are depressed, the current account deficit in the year ending June 1987 will show no improvement over the US \$9.6 billion deficit registered last year despite the weakened Australian dollar. In addition, Australian economists contend that Keating is overestimating real GDP growth for fiscal year 1986/87 at 2.2 percent, suggesting to us that the budget deficit will be larger than the government's projection of \$2.1 billion. According to press reports, currency dealers and credit analysts want to see more substantial economic policy changes that address labor unrest, wage increases that exceed productivity gains, and inefficient work practices. []

Key Constituents: Who's Gripping About What The Farmers. In our judgment, the depressed rural economy will hurt the Hawke government in the next election. Average farm income has fallen 71 percent since 1984, according to US Embassy reporting.

Australia's largest farm lobby, the National Farmer's Federation (NFF)—an umbrella group led by the charismatic and outspoken Ian McLachlin and representing 21 farm organizations and 170,000 farmers—supports economic positions compatible with opposition leader Howard's free market views. Convinced that high transport costs on unionized rail lines and through unionized dockyards are pricing Australian products out of world markets, the NFF has established a US \$10 million "fighting fund" to aid industrial employers enmeshed in union-related lawsuits. The NFF scored a significant victory in July 1986 when, for the first time, a federal court ruled that a trade union had conducted an illegal boycott against a private company. The legal fees of this suit were partially underwritten by the NFF. []

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More important for Hawke, the NFF is attempting to capitalize politically on public sympathy for farmers. Polls indicate that nearly two-thirds of Australians favor special assistance for farmers. The NFF has initiated nationwide protests designed to increase public awareness of the rural depression and, despite its free market rhetoric, has successfully pressured the Labor government for concessions for farmers. In early 1985, for example, Hawke was compelled to reduce tariffs on imported fertilizer and taxes on farm fuel in order to improve the Labor Party's prospects in several state elections, according to the US Embassy. []

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The NFF also prodded Hawke to protest the US decisions last year to offer subsidized wheat sales, through the Export Enhancement Program, to the Soviet Union and China—two of Australia's traditional markets for wheat exports—and to sell surplus sugar to China at subsidized prices. The NFF claimed that the US actions would cost the depressed Australian agricultural sector hundreds of millions of dollars in lost export revenue. Hawke, also under pressure by the left wing of the Labor Party, which claimed that the subsidies proved that Australia does not benefit from its security alliance with the United States, reacted angrily to the proposed sales and made a direct appeal to Washington opposing the measures.

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Hawke: A Good Mate to the United States

The Labor government has maintained strong bilateral relations with the United States since Prime Minister Hawke's election in April 1983. Hawke supports the US-Australian joint defense facilities, welcomes US naval ship visits to Australia, and is critical of New Zealand Prime Minister Lange's antinuclear legislation. Although Hawke opposes the Strategic Defense Initiative, in our judgment he has succeeded in dampening potential anti-US sentiment in Australia while maintaining Labor Party support for his generally pro-US defense and foreign policies. To do so, Hawke's relatively conservative Labor Unity faction has formed an alliance with Foreign Minister Hayden's moderate Center Left party faction to block foreign policy and defense proposals from the Labor Party's radical Socialist Left. For example, at the Labor Party's biannual conference in July 1986, Hawke and Hayden defeated a leftwing resolution calling for the termination of the joint defense facilities, according to the US Embassy. Labor's right and center factions also blocked several Socialist Left motions that would have expressed support for the Sandinistas, endorsed a more restrictive South Pacific Nuclear Free Zone Treaty, and attacked the ANZUS Treaty. []

Defense Cooperation. According to the US Embassy, an Australian defense white paper released in March 1987 strongly supports the US-Australian joint defense facilities, arguing that Australian security is enhanced by the joint facilities. Canberra's white paper also cites the potential threat posed by the Soviet Union in the South Pacific, according to the US Embassy. Defense Minister Beazley recently announced that Australia would seek to expand its influence in the South Pacific, thus addressing US concerns raised by an Australian defense review in May 1986 that Canberra would seek to adopt limited defense policies. As for US naval ship visits, Beazley has stated that the number of visits should be determined solely by the operational needs of the US Navy, and has urged the United States to increase the number of port calls in eastern Australia. In addition,

during a visit to New Zealand in December 1986, Hayden publicly rebuffed Lange over his antinuclear policy, and reaffirmed Canberra's commitment to the ANZUS alliance with the United States. []

Hawke, nonetheless, has not always been able to adopt pro-US positions in the face of Labor Party factional fighting. In 1985, Hawke reversed a decision to support MX missile testing in the Tasman Sea because he feared that leftwing opposition to the tests could undermine Labor Party support for the joint facilities and ANZUS, according to the US Embassy. Similarly, Hawke could not support the Strategic Defense Initiative for fear of provoking a leftist reaction, and Beazley has cited a potential antinuclear backlash in expressing reservations about possibly relocating the US Navy's Antarctic Operations base in New Zealand to Australia. Moreover, in return for Hayden's assistance in party infighting, Hawke has supported the Labor Party's criticism of Washington's policies on Central America, and has urged the United States to continue observing the Salt II Treaty. []

Bilateral Tensions. Australia's deteriorating current account balance is straining Canberra's relations with the United States. Washington's extension of the Export Enhancement Program to wheat exports to the Soviet Union angered Australian farmers and led Hawke to accuse the United States and European nations of pursuing protectionist agricultural policies. Although Hawke and Trade Minister Dawkins have warned that declining export earnings will ultimately limit Australia's ability to cooperate with the United States in regional defense plans as well as reduce bilateral trade, Hawke has refused to link trade and defense issues. Hawke has rejected a proposal from leftwing Labor Party members that Canberra charge the United States rent for use of the joint facilities, and opposed calls by farmers that Australia use the joint facilities to pressure the United States to reduce its agricultural subsidies. []

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Although Hawke was able to deflect leftwing criticism of the United States by refusing to link trade and defense issues, his inability to prevent adoption of the measures was, in our judgment, a major political defeat for him, damaging his credibility among Australian farmers because the Labor government appeared powerless to win relief from the US Government. []

The NFF claims to be nonpartisan and, according to the US Embassy, intends to challenge seats held by both Labor Party and the Liberal-National coalition in the next election. But we expect that the NFF will draw votes away primarily from the Labor Party because of the decline of the rural economy during Hawke's second term. McLachlin has already given the Hawke government cause for concern; the US Embassy reports that, following a heated exchange between Hawke and McLachlin during an aborted meeting last December, the NFF leader threatened to "go after" the Labor Party unless the government became more accommodating to farmers. Regardless of McLachlin's actions, we believe Hawke will remain vulnerable to organized rural pressure because Labor holds 12 rural seats, and the opposition needs to pick up only nine seats to win the next election. []

Businesses. Despite budget cuts and fiscal reforms such as floating the Australian dollar, Hawke's economic policies have antagonized the Australian business community, according to press reports. The government's 1986 tax reforms increased corporate taxes and multiplied administrative burdens associated with a new "fringe benefits tax," which holds employers liable for taxes levied on employee benefits. Hawke's 1987 budget, moreover, places the brunt of extra taxes on upper-income voters. According to press reports, businessmen are also critical of the Hawke government because they blame the government's expansionary spending, especially in the year preceding the December 1984 snap election, for the deterioration of Australia's balance of payments. As the recession eroded Australia's competitive position in world markets, conservative business leaders—dubbed the New Right by the Australian press—began a campaign of lobbying and political speech making favoring free market economic policies and a radical restructuring of Australian labor relations. []

These conservative business groups gained political prominence in August 1986 when the Peko-Wallsend Ltd. mining company defied the instructions of Australia's Federal Arbitration Commission by firing 1,100 employees in a dispute over restrictive work practices. According to the US Embassy, the company's president, Charles Copeman, initially enjoyed wide support because of a growing public perception that excessive union strength was harming the economy. Reacting to the rise of the New Right, opposition leader Howard voiced strong support for the conservative business groups and proposed sweeping reforms to the Arbitration Commission that would weaken the position of the trade unions by allowing small companies to opt out of centralized arbitration and by requiring the Commission to consider the effects its decisions will have on the national economy. []

Hawke, however, has moved to regain the political momentum from Howard and the New Right. While attacking the New Right's proposals as unconstitutional and un-Australian, Hawke began his own crusade against restrictive work practices through a government-initiated conference in September 1986 involving business leaders and trade unions. The conference, which resulted in unions' agreeing to modify some restrictive work practices, undercut Howard's proposals to reform the Arbitration Commission, in our judgment, by convincing some business leaders that the federal arbitration system could deal with problems faced by employers as well as unions. []

The Trade Unions. In order to be reelected, Hawke must have the continued support of the Australian Council of Trade Unions—the labor organization that Hawke led from 1969 to 1980—in moderating wage demands and limiting strikes. Hawke gained a major victory in December 1986 when the ACTU agreed to abandon wage indexation to the consumer price index (CPI) in favor of a two-tiered system guaranteeing a flat wage hike for all Australian workers and allowing unions to seek additional pay increases on a case-by-case basis. According to the US Embassy, the ACTU's decision to abandon CPI-based wage awards

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reflects the trade unions' weakened bargaining position caused by high unemployment and Australia's deteriorating terms of trade. The two-tier proposal, however, will probably anger highly paid white-collar and public service unions because the flat first-tier increase will represent a relatively small wage hike, according to the Embassy. []

Negotiations for the new two-tier system should buy some time for Hawke's economic policies by temporarily limiting wage increases, according to the US Embassy, but the wrangling over details could lead to tensions between the Labor government and the trade unions. For example, the size of the universal first-tier raise has yet to be agreed to and, in exchange for trade-union support, the ACTU will almost certainly demand an exclusion of pension payments and the 17.5-percent bonus paid to vacationing workers from the new wage-setting system. According to US Embassy reporting, the Labor government will probably pressure unions to keep annual wage increases below 6.2 percent, in line with government budget forecasts, which is certain to result in declining real wages for workers if inflation continues at the current annual rate near 10 percent. Details of the second-tier negotiations also have to be worked out, and, in our judgment, unions operating in financially stronger industries could use these second-tier negotiations to win increases in real wages for their members. As a result, stronger industries—especially those capable of competing abroad—could be hurt by the two-tier system. []

Looking Ahead

Timing of the Elections. According to the US Embassy, Hawke believes that a short campaign would minimize the opposition's chances, and, therefore, we believe he will call a snap election, rather than wait for his term to expire in April 1988, to prevent the Liberal-National coalition from getting an early start on the campaign. Although Hawke might be tempted to go to the polls before presenting another austerity budget in mid-1987, we believe it is unlikely that he would call for early elections while facing a troubled economy and while the opposition is doing well in public opinion polls. According to US Embassy and press reports, Labor Party officials, moreover, believe that the party has not yet secured

John Winston Howard



Leader of the Liberal Party—the senior partner of the opposition coalition—since September 1985 . . . strongly conservative: known as “Honest John” for his straightforward approach to politics, but suffers from a “dull” public image and trails Hawke in personal appeal . . . personal popularity in local polls plummeted in February 1987 to the lowest level since he became opposition leader . . . has law degree from University of Sydney, specialist in corporate and security law . . . age 47. []

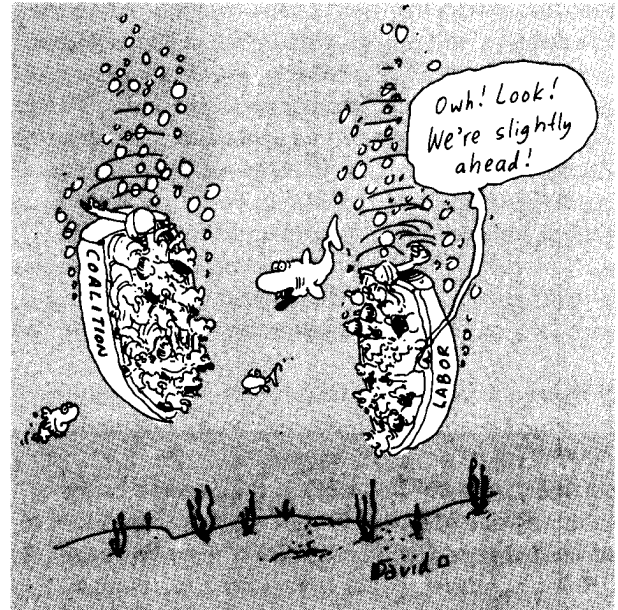
the support of some of its traditional constituents, such as environmentalists disaffected by Hawke's efforts to increase uranium exports, and consumers angered by high inflation and the increased costs of imports. Hawke, in our judgment, will probably need the second half of 1987 to try to mend political fences following the government's budget presentation, which is due in August, because press reports suggest that Hawke and Keating will be unable to avoid another austere budget. Following the budget campaign, however, we believe Hawke might try to take advantage of the normal Christmas season increase in public support for the governing party, as well as the good will generated by the Australian bicentennial in 1988, by calling a snap election in early 1988. []

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Hawke's Prospective Game Plan. Between now and the election, we believe Hawke will continue his program of incremental economic reforms that are politically acceptable, if for no other reason than to show the electorate that the Labor government is doing something about the economy. For example, many business leaders have pressed for a lower "youth wage," which the Labor government could easily enact because youth unemployment is now above 22 percent. In addition, the US Embassy reports that the government's plan for improving the quality of Australia's work force includes reducing marginal tax rates for high-income earners to arrest the "brain drain" Australia has suffered in recent years, and redirecting some funds for job creation into retraining programs. [redacted]

If the balance of payments does not improve significantly in the runup to the election, the Labor government probably will pass additional measures to encourage exports, such as granting exporters a reprieve from the new fringe benefits tax. In addition, the Hawke government may move to streamline the country's stiff regulations on corporate takeovers, which businessmen claim hamper their competitive position in world markets. In order to encourage domestic investment, Canberra may increase depreciation rates for businesses even though Keating is concerned about introducing measures that would reduce revenues from business taxes. Canberra may also take tentative steps toward tariff reform. For example, the Labor government is considering lowering tariffs on imported textiles, clothing, and footwear from generally over 100 percent to rates in the 75- to 50-percent range, according to press reports. Even if enacted over trade union objections, tariff reforms may do little to boost manufacturing competitiveness in these industries, in our judgment, as the rates would still be high by international standards. [redacted]

The Shape of the Coming Campaign. Because Australia's economy will almost certainly continue sluggish throughout 1987, we believe that the Hawke government is in danger of being defeated by the Liberal-National coalition in the next election. In our judgment, an improvement in Australia's trade imbalance, either through increased commodity prices or new markets for commodity or manufactured exports,



One Australian view of government and opposition performances [redacted]

would be too little, and come too late to boost the Labor Party's political fortunes. As the economy remains in its slump, opposition leader Howard should succeed in turning the campaign into a referendum on the Labor government's inability to move the economy after more than four years in office. According to the US Embassy, the Liberal Party leadership is confident that it need only exploit the right pocket-book issue to win the next election. [redacted]

Hawke, who already concedes that the economy is in poor shape, will try to focus his campaign attack on Howard and the New Right, in our judgment. Hawke will almost certainly appeal to traditional trade union and lower-class Labor constituencies by charging that Howard would adopt harsh economic policies that would place an unfair burden on low- and moderate-income workers, while protecting business interests. We believe, nonetheless, that Hawke will have difficulty attacking his opponent, because Howard will probably avoid proposing specific economic policies in order to prevent business and Labor Party criticisms of his proposals from drawing public attention away

from the government's economic troubles. Although this strategy will probably minimize conflicts within the opposition coalition between Howard's conservative faction and a moderate faction, the Labor Party will probably charge that the opposition lacks credible alternative policies. The risk Howard runs by adopting this strategy was apparent in two state byelections held in January 1987. According to the US Embassy, the Labor Party was able to hold both contested seats by charging that their Liberal-National opponents were long on criticism and short on alternatives. []

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If Hawke Loses. As prime minister, we believe Howard would probably compromise on his economic agenda, much as he did when holding the Treasurer's portfolio from 1977 to 1983 in the government of former Prime Minister Fraser. At that time, Howard succeeded in removing controls on short-term capital inflows, permitted banks to expand into new areas, and liberalized interest-rate controls. He had to abandon further reforms, however, including his efforts to float the Australian dollar, because of stiff opposition from members of his own party. In our judgment, Howard would probably backtrack from his more radical economic proposals, such as reforming the Arbitration Commission, in order to maintain the support of moderate coalition members led by former opposition leader Peacock, who would probably hold the Foreign Minister's portfolio. []

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As for bilateral security relations with the United States, Howard has stated his firm support for US regional and global policies. He supports the joint defense facilities, continued access to Australian ports by US Navy ships, and the Strategic Defense Initiative, according to US Embassy and press reports. Like Hawke, Howard advocates international arms control and would almost certainly urge Washington to reach such agreements with Moscow should he become prime minister. Unlike Hawke, however, who must deal with Labor Party leftwing skepticism of US foreign policy initiatives, Howard's main support would come from the business community and farmers as well as from conservative labor unions, groups that are generally strongly pro-United States. []

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Appendix B

Hawke's Second Term: A Chronology of Government Economic Policies and Political Consequences

1984

December

Hawke reelected as year of economic boom—with real growth exceeding 6 percent—ends.

1985

January

Unions demand pension plan increases in addition to wage indexing at the April wage round. Rash of strike activity threatens Price and Wage Accord negotiated in 1983 that provides for indexing wages to inflation. Keating attempts to mollify trade unions by expanding list of companies required to report price changes to the Prices and Surveillance Authority.

March

Queensland National Party government passes tough strike legislation ending 15 days of statewide strikes causing power outages and closed ports. Hawke and ACTU do not try to intervene.

April

Arbitration Commission grants wage increases equal to price inflation of preceding months, but postpones debate on pension plans.

May

Hawke's approval rating down to 52 percent. Liberal-National coalition leads Labor in polls. Hawke's handling of strikes and collapse of Australian dollar seen as responsible.

June-July

Labor Party's "Tax Reform Summit" founders in July because of Keating's proposal to impose a new 12.5 percent retail sales tax, which is attacked from all sides: the ACTU argues it would hit low-income earners hardest, 25,000 farmers march on Canberra protesting effect on production costs, business leaders claim it would frustrate investment and growth.

August

Keating scraps compromise tax reform package, hastily drafted—primarily by ACTU leaders—and approved by the conference, because it omitted the retail sales tax. The government's new budget is less expansionary, keeping Hawke's "trilogy" of campaign promises: increasing spending and taxation no faster than the rate of economic growth and lowering the deficit.

September

Hawke yields to union demands for fully indexed wage increases, reversing earlier promises to trim pay hikes to preserve export competitiveness. Business leaders charge ACTU controls the economic policy agenda.

1986

February

Hawke attempts to appease farmers to preserve Labor Party majorities in several state elections. Grants tariff rebates on imported fertilizer, then exempts fuels use in farm vehicles from new fuel tax.

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April	<i>Hawke visits Washington to appeal subsidized US competition in Australia's traditional agricultural export markets, particularly Middle Eastern grain markets.</i>
May	<i>Keating says Australia may become a banana republic if Australians do not tighten their belts. Australian Democrats—a small party holding the balance of power in the Senate—force the Labor government to abandon unpopular capital gains tax.</i>
June	<i>Hawke indefinitely postpones an economic summit called by Keating to discuss Australia's deteriorating trade position. Arbitration Commission allows 2.3-percent wage increases, but rules that pension increases will have to be negotiated with individual employers. As a result, strikes begin, but few employers grant increases.</i>
July	<i>Hawke and Keating triumph over left wing at Labor Party conference on almost all policy issues. Hawke protests US decision to offer subsidized wheat to USSR and China.</i>
August	<i>Keating issues austere budget, proposing zero real growth in expenditures. Determined to boost exports, Hawke lifts ban on export of uranium to France, causing uproar from the Labor Party's left wing. Meanwhile Liberal-National opposition jumps 10 points ahead of government in public opinion polls—Labor's worst standing since coming to office in March 1983.</i>
September	<i>Hawke's approval rating hits low of 45 percent.</i>
October	<i>Hawke bows to public pressure to review fringe benefits tax, modifying some of the more burdensome requirements.</i>
November	<i>Keating admits failing to file his income tax returns for two years, undermining his credibility as a Treasurer bent on closing tax loopholes. Opposition calls for his resignation, but Hawke dismisses incident as an "oversight."</i>
December	<i>Trade unions and businesses agree to decouple wage increases from consumer price index, but the Hawke government's goal of limiting wage increases is threatened as inflation approaches 10 percent.</i>
1987	
January	<i>Monthly trade deficit doubles from December 1986 as exports plunge sharply. Hawke warns that US agricultural subsidies threaten to erode Australia's ability to defend Western interests in the South Pacific.</i>

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